

# THE COVID-19 PANDEMIC AND THE ARM'S LENGTH PRINCIPLE

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**Abstract** The wide-ranging economic impacts of the COVID-19 pandemic suggest that previous analysis methods such as the arm's length principle can no longer be fully applied in the usual way. The SARS-CoV-2 virus has disrupted companies' accounting, administration, and controlling systems. These systems are essential for analysing the prices applied to related companies. Comparative data evaluation over time is essential to understanding an economic entity. The different measures governments have implemented to contain the epidemic and help businesses to operate have disrupted the economy. Thus, the year-on-year business performance is no longer comparable using annual historical data. Considering future changes in contractual relations analysis is also necessary because non-transitory factors should also be assessed. These factors are incorporated in the countervalue of pricing, which also changes the cost price calculation methodology. Determining force majeure situations is crucial in contracts since its assessment is a legal problem, even for independent undertakings. This paper aims to show how national GDP data help examine the application of the arm's length principle. Since the COVID-19 pandemic, internal comparative prices, pricing mechanisms and pricing principles have become more valued than the use of external comparables. This trend is expected to continue.

**Keywords:**

arm's length principle, comparability analysis, COVID-19 pandemic, GDP, OECD guidelines

## 1 Introduction

The application of the arm's length principle and its examination for multinational companies remains of particular importance following the emergence of the SARS-CoV-2 virus.

Coronavirus, which led to a pandemic in 2020, resulted in a crisis and has rapidly become a real challenge – one that was not only economic but also cost lives and had a social impact. Everyone has been confronted with the effects of COVID-19 and is a factor that everyone can see and experience (Szóka, 2020).

The economic impact of the COVID-19 pandemic has been particularly wide-ranging, therefore the previous methods of analysis can no longer be fully applied to the application of the arm's length principle.

The virus spread very rapidly, which, in addition to its impact on medical infrastructure, completely transformed our economy.

Different countries have experienced the emergence of the virus at different times and at various intensities, and most governments have tried to respond to the crisis with a wide range of measures to support the economy, jobs and people's incomes.

Changes in economic life and the actions of governments have raised some problems when examining the application of the arm's length principle.

The problems are complicated by the fact that the analysis itself is based on accounting data. The basic principle for comparing data is that it is always possible to compare indicators calculated on the same basis. This principle was violated during the crisis for the reasons mentioned above.

The aim of this paper is to show, in addition to the problems encountered, how national GDP data help to examine the application of the arm's length principle.

## 2 Examination of the arm's length principle

For guidance on the application of the arm's length price principle, please refer to the guidelines published by the Organisation for Economic and Cooperation and Development (OECD). In January 2022, the most recent single set of guidelines – OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022 – was published (OECD, 2022a). Prior to this, in December 2020, however, the changed economic environment following the SARS-CoV-2 virus made it necessary to draft a supplementary publication to provide a robust assessment of the arm's length principles during this period and beyond titled 'Guidance on transfer pricing requirements for the COVID-19 epidemic' (OECD, 2020).

The purpose of the guidance is to assist in applying a reasonable method of assessment during the relevant period in order to determine the arm's length price, which can not only be applied for tax purposes but also to provide investors and owners with a risk identification and control function.

Moreover, all this is an important area in the public sector in addition to the private sector. This is based on the fact that transfer pricing rules apply to companies with a decisive influence on municipalities just as they do to any other company, which, in addition to tax audits, also supports the application of the arm's length principle in the case of audits by the State Audit Office (Berényi, 2015).

### 2.1 Presentation of the company: comparison of the periodic results of the company

The first step in applying the arm's length principle is to use comparative data over time to show and evaluate the trend in the operation of a business in order to understand and describe it.

For the periods affected by COVID-19 and subsequent periods, this comparability analysis is of particular importance, and therefore as a first step in the comparability analysis, it is necessary to document the changes due to the epidemic and their impact for each business unit individually in such a way that it is necessary to show the change in the market, operational and financial risks of the business in each case.

The general problem is that comparability analyses typically rely on historical data, which may present a distorted picture for these periods.

To eliminate or avoid bias in comparability analysis, it is necessary to present a deeper analysis than previously expected, which will rely much more on well-developed management accounting principles (Hegedűs, 2020).

The role of management accounting is necessary to ensure comparability. A distinction should continue to be made between transactions with related parties and transactions with unrelated parties. In addition to this, however, it is necessary to identify the costs and expenses and, of course, the revenues that are incurred in the future and which are thus included in the selling price.

An important parameter is that it is also necessary to draw up statements for periods within the year in order to select test periods or exclude periods that would distort the comparison.

It should not be forgotten that several countries have experienced shutdowns of varying periods and intensity that have affected the operation of their businesses.

Macroeconomic information, the use of statistical methods and comparisons with projected internal fiscal data can also help in the analysis of a given period, for example macroeconomic information (e.g. country-specific gross domestic product (GDP) data) or industry indicators, public reports issued by central banks, government agencies, industry or trade associations.

When presenting a particular company, it is therefore useful to make comparisons with macroeconomic data in order to obtain a comprehensive picture.

## **2.2 Initial steps in creating an external comparison sample**

One of the accepted methods for assessing the arm's length principle is to compare the profitability of a company with similar activities and parameters with other companies.

A key issue in the method of analysis is to construct an external comparator sample of enterprises that are as similar as possible to the enterprise in question.

Similarity should not only be limited by activity and type of enterprise but also by size and geographical location.

In the context of the COVID-19 pandemic, the extent to which an international sample can be used is a particularly sensitive issue in the context of this comparative sample, due to the factors mentioned above (different intensity of the epidemic in different periods or the impact of different government measures in different countries).

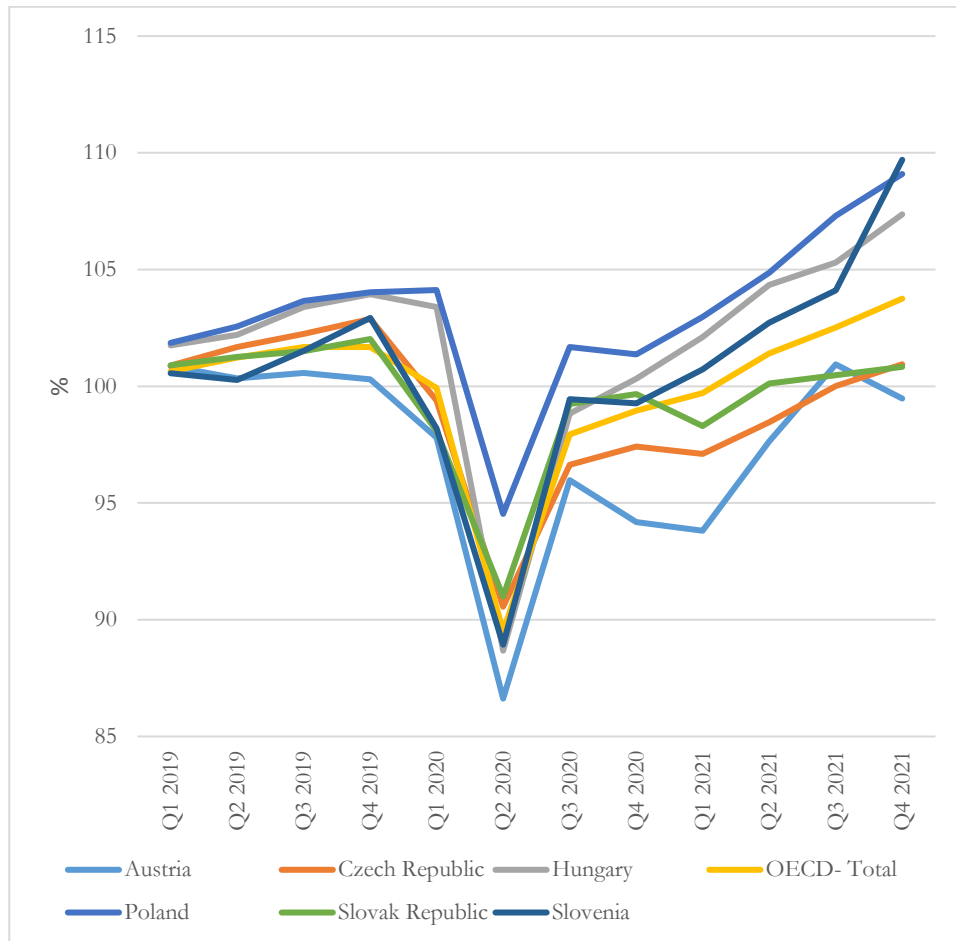
For this purpose, as an overview, the authors of this study examined the evolution of quarterly GDP data for a few countries, since the quarterly GDP data are good illustration of the impact on companies and that of the epidemic period. GDP is a standard measure of the value added generated by the production of goods and services in a given country over a given period, and is one of the most important indicators of economic activity.

In Hungary, based on the guidance issued by the National Tax and Customs Administration in May 2021 (entitled Application of international business databases containing firm-level data in transfer pricing), the sample of firms operating in the same or most similar macroeconomic geographic area as the market environment of the business under investigation should be selected from the sample within the country during the pandemic period (NTCA, 2021).

In the event that there are not enough samples in Hungary, the extension of the geographical condition should first be done for the V4 or V6 countries, followed by the EU member states of the Eastern European region, then the Central and Eastern European region, and if this is not sufficient, the EU-27 member states and the United Kingdom are proposed. As a further addition, EFTA countries (Iceland, Liechtenstein, Norway and Switzerland) could be added as a last resort to extend the survey to the global level.

Based on the data published by the OECD, and without claiming completeness, the indicators of the V4 countries and Slovenia and Austria are therefore examined in this analysis for the 2019-2021 period based on a quarterly breakdown.

The analysis clearly shows that for all the countries under review, changes can be seen over almost the same period, albeit to varying degrees.



**Figure 1: Quarterly GDP percentage change between 2019 and 2021 (Q4 2018 = 100%)**

Source: authors' own editing based on the OECD (2022b)

The COVID-19 pandemic first appeared in Europe in February 2020. In terms of quarterly data, the first quarter of 2020 was the first quarter to see a decline in GDP data, with the exception of Hungary and Poland. Hungary exhibited a minimal decline, while Poland showed a further increase. For Austria, the Czech Republic, Slovakia and Slovenia, GDP figures fell below their Q4 2018 levels.

Table 1: Quarterly GDP percentage change between 2019 and 2021 (Q4 2018 = 100%)

	Q1 2019	Q2 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020	Q3 2020	Q4 2020	Q1 2021	Q2 2021	Q3 2021	Q4 2021
<b>Austria</b>	100.86	100.34	100.57	100.30	97.80	86.62	95.98	94.18	93.81	97.63	100.94	99.48
<b>Czech Republic</b>	100.89	101.68	102.24	102.88	99.40	90.56	96.64	97.42	97.11	98.46	100.01	100.94
<b>Hungary</b>	101.75	102.20	103.40	103.95	103.40	88.67	98.83	100.33	102.11	104.34	105.29	107.36
<b>OECD - Total</b>	100.63	101.23	101.68	101.68	99.93	89.50	97.94	98.96	99.71	101.40	102.52	103.75
<b>Poland</b>	101.86	102.56	103.66	104.02	104.12	94.54	101.68	101.36	102.98	104.87	107.30	109.09
<b>Slovak Republic</b>	100.91	101.26	101.5	102.02	98.09	91.00	99.25	99.67	98.29	100.12	100.48	100.83
<b>Slovenia</b>	100.56	100.27	101.52	102.94	98.20	88.93	99.45	99.27	100.72	102.73	104.11	109.70

Source: authors' own editing based on the OECD (2022b)

Notes:

	The highest GDP data prior to the emergence of the pandemic
	The deepest GDP data due to the emergence of the pandemic
	Re-achievement of pre-pandemic GDP data

In the 2<sup>nd</sup> quarter of 2020, there was already a strong decline in all countries, followed in Q3 by a larger improvement and then by a slow increase.

For the countries under review, the GDP figures for Q4 2019 were able to compensate for the economic downturn following the onset of the COVID-19 pandemic for a different period. Some countries, such as Hungary, Poland and Slovenia, reached their pre-pandemic GDP levels after Q2 2021, while others, such as the Czech Republic and Slovakia, did not even reach their pre-pandemic GDP levels in Q4 2021.

Looking at OECD countries in general, it can be concluded that the economies of OECD member countries collectively were able to reach the pre-pandemic level of COVID-19 by Q3 2021, with the highest level in Q3 2019.

### 3 Conclusions

In the analysis of the six countries, it can be concluded that in the case of an international comparison, due to the COVID-19 pandemic, it is necessary to take into account that each country experienced the epidemic at a different time and with different intensity. Therefore, if it is not possible to find enough samples within a country, it is worth extending the sample to countries that experienced the same intensity in economic life during a similar period, which can be achieved by mapping the GDP trends of the countries concerned.

Given that these effects have varied across industries, it may be worth looking beyond the variation in national data to examine the comparative sample of the firm under investigation at a sectoral level.

In addition, analysing the evolution of the GDP of a company's country at the industry level may also allow further correlations to be identified, such as the extent to which the company in question fits into the pandemic situation during this period.

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